You're in Charge!
Case Study and Questions

You have been recently assigned to Parador. You're looking forward to this tour because the lifestyle is great! This is a country being hailed in the financial press as an emerging market. There is no exact definition of this designation, but at the very least, it connotes recent economic success.

Those who study Parador argue that its growth or development strategy has been to integrate national production, particularly in manufacturing, with international production. During the past two decades, the country has shifted from a predominantly commodity-based economy to increasing assembly of export manufactures and recently has had some success venturing into higher-tech products. Parador has started but not completed the process of financial market liberalization and reform. Parador is negotiating to join the WTO and will have five years to comply fully with WTO.

Capital inflows into Parador are averaging over 10 percent of GDP. They include borrowings by banks and financial institutions as well as by the government. The Central Bank seems to be absorbing the risks of exchange rate movements on behalf of investors, which is helping to encourage capital inflows, especially those of a short-term maturity. The exchange rate is appreciating in real terms as capital inflows put upward pressure on the prices of non-traded goods (land, buildings). Domestic bank lending is expanding rapidly. An increasing share of borrowing is being used for real estate, property, and purchases of equity funds.

Export growth, measured in current US dollars, is beginning to slow. Fierce competition is being felt in Parador's non-traditional export products from low-cost producers such as China and India.

The government has been running a budget deficit, financing it mainly from foreign borrowing. Nonetheless it has maintained overall money growth at a prudent level and has avoided double-digit inflation.

Below are some of the key economic, social, and financial indicators of Parador.

Selected Economic, Financial, and Social Indicators for Parador		
Indicator		**Notes**
Average annual GDP growth 1990-1998	8%	
GNP per capita, 1998	$1,050	PPP GNP at $3,800
Average annual population growth rate 1980-1998	2.5%	
Infant mortality rate, 1998	30 per 1,000 live births	compared to 70 in 1980
Population below $2 a day	40%	
Percentage share of income or consumption, ratio of highest 10% to lowest 10%, 1997	22	

Population with access to safe water, 1990-1996	70%	
Average annual deforestation, 1990-1995	2.5%	
Telephone main lines per 1,000 people	25	lowest in the region
Adult literacy rate, 1998	85%	from 68% in 1970
Gross secondary school enrollment rate, 1998	57%	below regional average
Export of goods and services, % of GDP, 1999	50%	compared to 30% in 1970
Current account balance as % of GDP, 1999	-5%	
Ratio of short-term foreign debt to foreign exchange reserves	1.2	or 30% of exports
Gross international reserves	3 months of import coverage	
Gross domestic savings, % of GDP, 1998	20%	
Overall government budget deficit	3% of GDP	
Deficit financing from abroad	2% of GDP	
Inflation rate, 1999	9%	
Prime rate (nominal), 1999	15%	

Scenarios and Questions about the Country Case:

1) Devaluation is imminent in Estelasia, the country next door. Although Parador has been viewed as more "advanced" and "prudent" than Estilasia in its economic and institutional development, it has significant trade relations with Estilasia and shares some common characteristics such as natural resource base, cultural heritage, trading partners and foreign investors. You have been asked to provide an emergency briefing to the Ambassador/Mission Director on implications of financial contagion on Parador, and options for Parador's government to preclude or minimize cross-border contagion. Please summarize your assessment in a five-minute presentation, bringing into your analysis capital flows, the current account, and the real appreciation of Parador's exchange rate.

2) Parador's new, progressive government has announced an ambitious economic development plan, aimed at installing modern infrastructure and upgrading education and health standards. The problem is that the nation's budget is already in deficit for several years. The Mission has been asked to advise the government on options for tax measures (e.g., raise import duties, raise personal or corporate income tax rates, introduce a VAT, place a sales tax surcharge on luxuries, etc.) to improve the budget balance. However, a key goal posed by the government is to avoid adversely affecting Parador's poor and also not stifling the private sector. What would you suggest?

3) The Government of Parador has just announced an ambitious disaster relief and reconstruction effort in response to a recent earthquake. The package will cost the government a considerable sum over the next five years, and put the budget in higher deficits (5% of GDP) over that period. The Mission Director calls you in to discuss the possible monetary policy responses – financing options for the government – before his/her meeting with the Minister of Finance. Specifically the government has been weighing how much to borrow from the international financial markets, and how much to

monetize. The Mission Director wants your view on the implications of alternative financing sources.

4) The ratio of the incomes of the top 10% to the bottom 10% of Parador's population is 22. There are two schools of thought in the Mission on the issue of equity. One side has the view that at the present stage of the country's economic development, the income distribution generally worsens with growth. The other side holds that unless there is some improvement in income distribution during a growth episode, the episode is likely to be a brief one. What school of thought would you support and for what reasons? What particular policies or initiatives would you suggest to improve Parador's equity performance during the current period of economic growth?

5) The price of Parador's primary export commodity, coffee, suddenly dropped by 50%. Coffee exports represented 30% of Parador's export earnings prior to the price collapse. At the same time, interest rates in the United States have been steadily rising and the U.S. Federal reserve has indicated that future rate hikes are likely. The Mission Director requests a briefing from you on the implications of these developments on Parador, and what are the options for the Government to prevent a balance of payments crisis. In addition, please note specific measures that could help accelerate Parador's diversification of economic activities and export composition.

6) A new, more populist President has been elected in Parador in the past week, after twenty years of a "soft" dictatorship under a leader who has squandered treasury funds on family and associates, and on wasteful projects. The President-elect has vowed to steer the country in a new direction, focusing on social services, the poor, and the environment. The President is not opposed to free trade but has used the term "fair trade" in his campaign. The U.S. Ambassador has scheduled a meeting with the President-elect and you have been asked to provide a briefing to him regarding Parador's development needs and priorities, and the role of trade and foreign investment in Parador's development.

* Note: This case study is adapted by SRI International from an original case study developed by Orest Koropecky of USAID.